EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Press release

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Stress test shows euro area banking sector could withstand severe economic downturn

- Exercise showed three years of severe economic stress would cut CET1 ratio of ECB-supervised banks by 4.8 percentage points to 10.4%
- Improved asset quality and profitability helped banks stay resilient amidst highly adverse conditions
- Exercise covered 98 (57 large and 41 medium-sized) euro area banks under direct ECB supervision

The European Central Bank (ECB) today published the results of its 2023 stress test, which show that the euro area banking system could withstand a severe economic downturn.

The Common Equity Tier 1 (CET1) capital ratio of the 98 stress-tested banks would fall by 4.8 percentage points on average to 10.4% if exposed to three years of stress under very challenging macroeconomic conditions. The CET1 ratio is a key measure of a bank's financial soundness.

The ECB stress tested 98 banks under its direct supervision. Of those, 57 are the euro area's largest banks which are included in the EU-wide stress test coordinated by the European Banking Authority (EBA), and 41 are medium-sized banks outside the EBA sample. Together they represent roughly 80% of total banking sector assets in the euro area. Earlier today, the EBA published detailed results for the 57 largest banks. The ECB has published selected data for the 41 medium-sized banks.

The stress test measures how banks would fare in a hypothetical adverse economic scenario, which assumes a prolonged period of low growth, elevated interest rates and high inflation. It is not a "pass-or-fail" exercise, and no threshold is set to define the failure or success of banks. Instead, the findings of the stress test will feed into the ongoing supervisory dialogue, in which supervisors explain their assessment to banks and discuss potential measures to address any shortcomings.

Credit and market risk as well as lower income generation drove the negative capital impact in the adverse scenario. Loan losses generated 4.5 percentage points of CET1 ratio depletion, with

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unsecured retail portfolios being the most vulnerable. Banks were also required to come up with sector-specific loan loss projections and projections on their leveraged finance exposures in the loan book and the underwriting pipeline. The review showed that leveraged finance exposures are riskier in a downturn and that many banks need to improve their valuation of the pipeline, modelling and data aggregation capabilities.

Meanwhile, 1.4 percentage points of total capital depletion can be attributed to market risk, particularly revaluation effects stemming from positions measured at fair value. Banks' income generation capacity also suffers in the adverse scenario, with lower net interest income, dividend income and net fee and commission income overall leading to 3.6 percentage points less CET1 capital than in the baseline. Importantly, the stress test showed that banks' ability to generate net interest income under an adverse scenario of increasing interest rates crucially depends on their business model and associated asset-liability structure. For example, banks with a larger share of variable-rate loans benefit more from rising interest rates than those relying mostly on fixed-rate loans. Therefore, the ECB currently requires banks to pay close attention to how they manage interest rate risks.

Capital depletion at the end of the three-year horizon was lower than in previous stress tests. This was mainly due to banks overall being in better shape going into the exercise, with higher-quality assets and stronger profitability. For some banks, the quality of their loan portfolio had improved significantly since 2021. These factors helped banks weather the adverse scenario, which assumed a prolonged period of high inflation and elevated interest rates. In many cases, the beneficial effect of rising interest rates on interest income still offset the stress on funding costs. On the other hand, banks' administrative expenses were projected to rise due to higher inflation.

The smaller banks in the ECB sample experienced higher capital depletion than the larger ECB-supervised banks (6.6 percentage points, compared with 4.6 percentage points). This was due to their lower income generation capacity and higher loan losses over the projection horizon. However, their CET1 ratio was still higher than their larger counterparts (13.7%, compared with 10.1%) as their starting position was also higher (20.2%, compared with 14.7%).

Integration into the SREP

When assessing banks' governance and risk management as part of the annual Supervisory Review and Evaluation Process (SREP), supervisors take certain qualitative outcomes from the stress test exercise into account, such as timeliness, data accuracy and quality of information.

Furthermore, the quantitative impact of the adverse stress test scenario is a key input for supervisors in determining the level of Pillar 2 guidance (P2G). The P2G is a bank-specific recommendation that

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indicates the level of capital the ECB expects banks to maintain on top of their statutory capital requirement. It seeks to ensure that a bank's own funds can absorb potential losses resulting from stress scenarios.

In the 2023 SREP, the ECB will for the first time apply a new methodology to determine the leverage ratio P2G to address the risk of excessive leverage. At system level, the leverage ratio of euro area banks decreased by 1.1 percentage points under the adverse scenario. It reached 4.4% by the end of the projection horizon, above the 3% minimum that is legally required. Leverage ratio P2G is imposed only for certain banks, for example where the projected leverage ratio falls below the overall leverage ratio requirement.

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Notes

- The final sample included 41 medium-sized banks instead of the 42 announced at the launch of the exercise. This was because of the acquisition of Biser Topco S.à.r.l. by OTP Bank Nyrt in early 2023.
- Some directly supervised banks did not take part in either stress test. This occurred, for example, if they were subsidiaries or branches of non-SSM banks that were participating in the EU-wide exercise. Other reasons for exclusion might have been that a bank was undergoing restructuring at the time or was involved in a merger or acquisition.
- For better comparability, all CET1 capital ratios mentioned here reflect the "fully loaded" basis, which assumes that banks already fulfil all regulatory capital requirements that are subject to transitional arrangements.
- In the 2023 stress test, banks used, for the first time, prescribed parameters for the projection of net fee and commission income. Previously, they had used their own models.
- Bank projections were calculated based on the accounting rules that were applicable as of 31 December 2022. As the IFRS 17 accounting standard for insurance activities only entered into force on 1 January 2023, this was not considered in the exercise. To ensure sufficient transparency, the EBA has however disclosed selected memorandum items which include the impact of IFRS 17. This should facilitate comparisons between the stress test outcome and the relevant capital ratios as of 1 January 2023. These memorandum items have however not been subject to the same thorough quality assurance as performed by competent authorities for the other published stress test data.
- To determine the P2G, ECB Banking Supervision applies a two-step approach. In step 1, each bank is placed in a bucket based on its maximum fully loaded CET1 capital depletion in the stress test. In step 2, supervisors determine the final P2G within the ranges of each bucket and, exceptionally, beyond them according to the specificities of each bank.
- To set the leverage ratio P2G (P2G-LR), the ECB will use the leverage ratio projections in the adverse scenario of the stress test as a starting point and follow a similar two-step process as described for the P2G above.

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